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Volume 18 • Number 3 • October 2005

Beneficial Changes to Bankruptcy Preference Defenses

By: Ira Goldberg

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Act") was signed into law by President Bush on April 20, 2005. Subject to some exceptions, the Act will take effect in bankruptcy cases filed on or after October 17, 2005. The Act contains many changes to the Bankruptcy Code ("Code"). One change, which will be beneficial to parties conducting business with companies that may be heading into bankruptcy, is broadened defenses to preference actions.

A preference action is one in which a Trustee or bankrupt seeks to avoid and recover certain transfers made to a non-insider within 90 days of the filing or to an insider within a year of the filing. The Act broadens the defenses available to vendors who have done business with a company which becomes a debtor in a bankruptcy case.

The typical preference is a payment received by a vendor within 90 days of the filing of a bankruptcy petition on an outstanding and overdue invoice (arguably an expedited payment can also be preferential). The debtor or its bankruptcy Trustee can avoid certain of these payments. The preference recovery provisions of the Code are designed to achieve fairness. The law presumes that the debtor is insolvent. It is deemed unfair that certain vendors are lucky enough to be preferred and receive a payment on an overdue invoice while there are other creditors who do not receive any payment whatsoever in the 90 days prior to bankruptcy. Therefore, preference payments can be recovered and returned to the bankruptcy estate for redistribution to the entire creditor body.

In theory, the preference provision of the Code is fair. However, in practice, every person who receives a dreaded Trustee letter seeking the return of monies paid within the 90 days prior to a bankruptcy case feels victimized. However, the Trustee's letter is not the end of the story. When you receive such a letter, you should explore available defenses, not write a check. The initial demand for a return of a preference is the beginning of a process and the commencement of a negotiation. The Code provides several defenses to those who regularly transact business with a debtor company. In the majority of situations which we encounter, we are able to achieve for our clients significant reductions, if not total defenses, to the supposedly avoidable preference asserted by the Trustee.

One of the most common Code defenses is the "ordinary course of business" defense. Under the amendments to the law which go into effect on October 17, 2005, the ordinary course of business defense will be much easier to establish. The crux of the broadened preference defenses is that the prior law required that payments be made in the ordinary course of business of both the transferee and the debtor and in addition that the transfer be made according to ordinary business terms (i.e. ordinary terms according to the relevant industry standard). Under the prior law, you had to meet both a "subjective" (business practices of the parties) and an "objective" (business practices of the industry) test. The Act makes these tests an either/or proposition. Under the old law preference defendants often had trouble meeting the objective industry standard. In order to prove the industry standard, courts frequently required them to present testimony from an industry expert or a competitor. This burden was not only difficult, but also costly or impractical. The ordinary course of business may be established by proof of an established business relationship (several years or many transactions) together with a showing that normal payment terms were followed as to the alleged preferential transfers at issue. For example, regardless of the fact that invoices provide that payments are due in 30 days, if it is the parties' routine custom, over a relatively long period of time, to have payments made within 60 to 90 days of invoice, this should establish the ordinary course of business. Therefore, in circumstances where there is an established history between the parties and the payments are made within those terms it would be easier to defend a preference action. When the relationship is a first-time one, or it has not been very long, some proof that industry standards were followed will be required. Other common defenses are: a) providing subsequent new value to a debtor after the receipt of the alleged preferential transfer, b) exchanges that are intended to be and in fact are substantially contemporaneous, and c) the fact that pre-payments are not preferential since an antecedent debt is not being paid.

For cases involving primarily commercial debt (not consumer debt) the Act precludes avoidence if the aggregate value of the property that constitutes or is affected by such transfer is less than $5,000.00. However, it is possible that a Trustee might still sue (forcing this defense to be raised as an "affirmative defense") or still send a demand letter for a sum under $5,000.00. For cases involving primarily consumer debt, the threshold is $600.00.

If you receive a Trustee demand letter, you should consult with bankruptcy counsel rather than issuing a check. In most circumstances you can settle (but only with court approval) for a percentage of your exposure. Please contact us about any questions you may have concerning this or other provisions of the Act.

Business Breakups

By: Lin Hanson

Not all marriages last. Neither do all business partnerships. Taking the time, and making the effort to sit down at the beginning of a business relationship to talk through issues - issues of decision making, income sharing, and yes, even breaking up, should bear good fruit in long term business relationships.

This article seeks to help you develop a checklist for drafting an agreement, or for dealing with a breakup when it happens.

Issues to be addressed are virtually identical whether the entity is a corporation, a partnership, or an LLC. The agreement will have a different name: either buy/sell agreement, shareholder's agreement, partnership agreement or operating agreement. The entity itself or other owners can be the buyers. Top tier issues are triggering events, price and terms.

What events cause a buyout? Death? Disability? Dissociation? What if one member simply wishes to withdraw? What about "simultaneous offers?" (one party states a price and terms, and allows the other party to decide whether to be Seller or Buyer).

Will the price be based on a formula? If so, what factors will be used? Asset Values? Earnings? Gross Sales? Multiple Factors? Is there a standard in the industry or profession for what the formula should be? Perhaps there will be a fixed price, and the parties agree to sit down at regular intervals and negotiate a new purchase price. Will the agreement call for an appraisal or some kind of arbitration to arrive at a price? Will an audit be required, or will financial statements of the company be relied upon?

Once the price has been determined, will it all be payable in cash, or will a portion be payable over time? What security will the Seller receive? Will the assets of the business be mortgaged? Will the Buyer be personally responsible for the payment of the balance? Will the Buyer's spouse also sign? Will the Buyer's personal residence be security (second mortgage)? Will the purchased stock, partnership interest, or membership interest be pledged? What about the Buyer's original interest in the company? The longer the Seller is away from the business, the less likely that he or she can successfully return.

Having considered the "top-tier" of issues, there are myriad secondary issues. When borrowing money, small businesses often must provide personal guarantees of the owners. Can the Seller be released? If not, can the Seller be satisfactorily indemnified? How will the parties share the burden of personal guarantees? Do they intend to share the obligation pro rata? Or will it be possible for a third-party creditor to collect from one alone?

What about other liabilities of the business? The Seller may have a concern about an ongoing relationship with suppliers and other creditors. What about contingent or unknown liabilities of the business? Issues such as product liability, or personal liability in connection with malpractice should be considered. Who pays the cost of "tail" coverage? Will the Seller agree to cooperate in the defense of future claims, including being a witness, if necessary?

Are there contracts with third parties which will be adversely affected by the sale? Does the business have franchise or other agreements which are open to termination if an owner leaves? Example: sales rep or loan agreements which can be canceled or called if an owner leaves?

The accounting techniques of many small businesses are aimed at minimization of income taxes. Accelerated depreciation, understated inventory values, under-reported income, and other similar factors are examples. How the parties address the effect of these techniques at the time of the breakup is another factor. It will be the Buyer alone who must deal with the situation after the Seller has departed.

The tax consequences of the breakup itself must be dealt with. Will the buyout result in capital gain to the Seller? If so, it is unlikely that the Buyer will be able to deduct the payments. On the other hand if the Buyer is able to deduct the payments,

Nursing Home Third Party Guarantees May Not Be Enforceable

By: Jane Kaminski Simers

The Nursing Home Reform Act of 1987 prohibits nursing homes from requiring third party guarantees as a condition of admission. This Act applies to every resident of any nursing facility certified to accept payment from Medicare and/or Medicaid. The Medicaid Act also makes illegal the conditioning of admission or continued stay in a nursing facility on a third party guarantee of payment.

Despite these prohibitions, nursing home contracts often require or appear to require the signature of a third party that imposes personal contractual liability on the person signing as the "responsible party," "agent," "legal representative," or other similar term. Some contracts require that the third party agree to pay fees or charges incurred by the resident out of the income and resources of the third party or that the third party will become personally liable if the resident or third party fails to pay promptly.

Some facilities maintain that the third party's promise to pay is voluntary and therefore enforceable. A California Court of Appeals struck down such a "voluntary" provision in Podolsky v. First Healthcare Corp., 58 Cal. Rptr. 2d 89 (1996). The court held that including such a "voluntary" provision was an unfair or misleading business practice and was an attempt to induce family members to obligate themselves personally in the midst of the confusion and trauma of placing a loved one into a nursing home.

Nursing homes count on the third party to pay upon receipt of a bill or in response to a demand letter threatening a lawsuit and liability for attorney's fees and cost of suit. The nursing home may file a law suit to collect, having been advised that the expense of defending a law suit, even if without merit, will encourage the third party to enter into a payment agreement in order to settle the dispute.

Nonetheless, a third party should not sign a contract unless the third party is the resident's guardian or the resident's agent under a power of attorney. It is preferable, whenever possible, that the resident sign the contract. If a third party signature is required, the signing party should strike out each clause that imposes financial liability on the signing party personally. Generally, nursing home admission personnel are not trained nor authorized to negotiate the contract and they are usually more concerned with whether the contract is signed at all.

it is likely that the Seller will be receiving ordinary income, rather than capital gain or a tax-free return of his or her investment. Perhaps the tax burden will be reflected in the selling price. Often the Buyer can afford to pay more, if the Buyer can deduct the payments. Sometimes the Seller can afford ordinary income treatment if the Seller's post-retirement tax bracket is low enough. Sometimes deductible items such as a covenant not to compete, consulting agreement, or retirement benefit can be substituted for a high purchase price. Interest is a factor to be considered, and if no interest is included, imputed interest will be deductible by the Buyer and taxable as ordinary income to the Seller.

Will the Buyer require the Seller to agree not to compete within a certain geographic area or with regard to certain key customers? How long? Who will have the right to continue to use the existing business name, service marks and trademarks? What about key business employees? What about the intellectual property of the business? Will the Seller be able to continue to use the customer lists, techniques and processes learned during the Seller's years of association with the business? Who owns the patents, trade secrets and other confidential information of the business? Are there "shop rights" to be dealt with in the breakup agreement?

Is the company telephone number a key asset, and who will own it? Are there appropriate licenses for all the computer software, and who really owns it? Is the business going to lose an economic advantage because the Seller is a member of a minority group, or female? Will life insurance be used to pre-fund the agreement? What about disability insurance? At the time of the breakup, what about the existing insurance policies? Will the Seller be permitted to purchase existing life insurance policies on his or her own life? Will the Seller also be obligated to sell existing insurance policies on the Buyer's life? Does the Seller have health issues personally or in his or her family? What about COBRA and other health insurance issues?

Once the Agreement has been written, it is a good idea, too, to make it a part of a regular review process. If, as Robert Frost observed in Mending Wall, "good fences make good neighbors," good agreements make good partners.

Mechanics Lien Act From An Owner's Perspective

By: David Arena

Our last issue explained how the Illinois Mechanics Lien Act provides a powerful collection tool to general contractors, subcontractors and material suppliers who provide labor or materials for the construction of improvements on private projects. The Act allows a contractor or material supplier to force the sale of an owner's property to pay the contractor's claim with the sale proceeds. However, the Act also provides the owner with a method to protect his interest in the property.

An owner who has a written contract with the general contractor, documents all change orders in writing, obtains a contractor's sworn statement and waivers of lien prior to making a payout and has documentation of all payouts, can defend against a contractor's claim for lien and protect the property.

One scenario where an innocent owner may have problems with mechanics lien claims of a subcontractor or material supplier is the bankruptcy of a general contractor. Consider: The general contractor performs under its contract with the owner by employing subcontractors to perform the work. The general contractor submits a pay request to the owner in the amount of $50,000, $30,000 of which is to be disbursed among the subcontractors. After receiving payment from the owner, but before disbursing funds to the subcontractors, the general contractor declares bankruptcy. The unpaid subcontractors perfect their lien rights and ultimately file suit to foreclose on their mechanics lien claims. Unless the owner has complied with the Mechanics Lien Act, he may be forced to pay the $30,000 due the subcontractors twice in order to avoid the sale of the property to satisfy the lien claims.

The Act affords protection to an owner who complies exactly with the Act's requirements. First, an owner should have a written contract with the general contractor that clearly defines the scope of work to be performed and the amount the owner will pay for the work. Any changes in the scope of the contract work or the contract price should be memorialized in a written change order. Second, before making payments to the general contractor, the owner should demand the general contractor's sworn statement which identifies all of the subcontractors the general contractor employed to perform the contract work, each subcontractor's total contract price, changes to the contract price, amounts previously paid, amount to be paid under the current draw request, and the balance due. At the time of making payment on a draw request, the owner should obtain lien waivers from the general contractor and subcontractors which correspond to the values on the contractor's sworn statement.

Under the Act, an owner is only required to pay for the work performed, the amount due under the contract, and change orders. This includes the cost to retain a replacement contractor to complete a defaulting general contractor's work. In addition, the Act provides that the owner may rely on a contractor's sworn statement in making payouts. This means that if a subcontractor's contract price is identified as $50,000 on the contractor's sworn statement, the owner is only obligated to pay a total of $50,000 on that subcontractor's claim even if the general contractor had promised funds in addition to $50,000 to that subcontractor. Finally, an owner who complies with the Act and who receives lien waivers from the general contractor and subcontractors protects the property from claims for funds which were previously disbursed.

Every participant in a private construction project should have a fundamental understanding of the mechanics lien process. An owner who complies with the Act's requirements can protect his property from the auction block. Lawyers of Di Monte & Lizak have been practicing in the area of construction law for over 44 years and regularly counsel parties in the construction industry, including general contractors and subcontractors, home owners and condominium associations, owners and developers, financial institutions and material suppliers.

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